

### **Avenue Fee Cut**

**In keeping with Avenue's policy and commitment to being aligned with our clients, we will be cutting our management fee in half for the Equity portfolio in 2016, due to a negative rate of return. This applies to all Equity accounts for clients who had joined Avenue as of January 1<sup>st</sup> 2015.**

### **FOURTH QUARTER 2015 - MARKET COMMENTARY**

2015 was a hard and stressful year. At times it felt like mini-crisis after mini-crisis. By year-end, Avenue's bond portfolio was up a bit and Avenue's equity portfolio was down slightly. Low interest rates continue to be a challenge for returns in the Bond portfolio. However, the equity portfolio is faced with multiple challenges from currency, from commodities, and from investors' perceptions of the future direction of interest rates. On the positive side, the high yielding stock investments that we favour are now at decent valuations and we believe they should offer better returns this coming year.

During this quarter we experienced the first interest rate increase in the US in nine years. This rate increase had a chilling effect on the higher yielding sectors of the stock market, but the Canadian bond market was little affected. The Canadian economy continues to slow. Stephen Poloz, the Governor of the Bank of Canada has indicated that he likes short-term interest rates where they are and has a bias towards lowering them again. However, our expectation is that we can earn a 3% to 3.5% rate of return over time in this environment given our exposure to medium-term Canadian corporate bonds. We are also looking for opportunities to make investments in higher yielding corporate bonds, which are currently experiencing a sell-off.

In past letters we have touched on the various global crises, like war in the Middle East and the stalling of the Chinese economy, to show how slowing growth affects commodities and the financial markets in general. The decline in interest rates and commodities is well documented but we must not forget that the consequence of global bad news is frequently a rising US dollar as a safe haven in an uncertain world. The Canadian dollar is trading down in tandem with other commodity based currencies like those in Mexico, Australia and Brazil. This rising US dollar, as

a reaction to bad news, is now a well-established trend and trends tend to continue and may reach an extreme.

From a Canadian investor's point of view we are starting to see a panic reaction much like the last time the Canadian dollar was in the 60 cent range in 2001. Yes, in retrospect, when the Canadian dollar was even with the US we should have taken all our money and just bought Amazon. In reality, it is very hard to predict the timing of world events such as a Chinese financial crisis or an Arab spring.

When valuing the Canadian to US dollar relationship, we like the concept of purchasing power parity, which is when an identical item, sold in either the US or Canada, would be of the same value. Currently using this method, the Canadian dollar's purchasing power parity with the US dollar is about \$0.85. The purchasing power parity between America and Canada has been an amazingly stable relationship over the last 50 years. So at one point in the recent commodity boom when the Canadian dollar went almost to \$1.10, this relationship said that the Canadian dollar was 30% overvalued. Now that the Canadian dollar is close to \$0.70, the currency is 20% undervalued. As we have already discussed, trends can go to an extreme and a 30% oversold situation is possible. But we can say, the Canadian dollar is undervalued and we have good businesses in Canada that we would like to own at these stock prices.

For about a year now, we have been writing that there is relative value in the Canadian dollar and we have been gradually moving investments back from the US, while the Canadian dollar has been losing value. This is much the same way we were gradually increasing our investments in the US when the Canadian dollar was high versus the US. Below, we have made an attempt to break down the portfolio by currency exposure. We would also strongly argue that we have true US dollar exposure in Canadian, TSX listed companies like Element Financial which has large leasing businesses across the US. The business and assets of the company are in the US and the income stream is in US dollars.

Avenue's Equity portfolio's currency exposure as of January 9, 2016.

20% Direct US listed Companies  
13% Indirect US exposure through Canadian listed Companies  
3.5% Other International Companies  
**36.5%** Total International Companies  
5.8% Gold Companies  
**42.3%** Total International Companies & Gold Companies  
versus  
**31.8%** Direct Canadian Companies  
25.9% Cash & Canadian high yield bonds and MICs  
100%

First, a brief explanation that the Cash and Canadian high yield bond and Mortgage Investment Companies (MICs) position is kept as an insurance policy within the portfolio, where we try to maintain a 20% weighting. If there is an extreme market decline, we can use this money. But for the most part it returns a less volatile income stream. This is a very effective strategy which helped us get through 2008.

We do have cash at the moment which is the un-invested 5.9% above our 20% target weight in the Cash and Canadian high yield bond portion of the portfolio. Excess cash is kept in Canadian dollars. We have been asked if the excess cash can be kept in US dollars and the answer is no. We could view this as a limitation of how we are structured, given that many of our portfolios are RSPs. The reality is that multiple currency cash strategies are expensive and more importantly we feel that keeping the cash in Canadian dollars lowers risk. For the most part, our clients live in Canada and therefore their expenses are Canadian based. With long-term pension type investing, the simple answer is to match assets and liabilities. However, if a client spends significant time in the US, then this is a different matter and can be addressed individually.

So when we look at our equity exposure we see a Canadian weighting of 31.8% versus a non-Canadian weighting of 36.5%, with 5.8% in Gold. Much of the US exposure was purchased when the Canadian dollar was above \$0.90. Today we have excess cash and we see value in good Canadian businesses that pay a dividend. The yield on our 31.8% weighting to Canadian stocks is about 5.2%. As a comparison, the TSX index yields 3.4%.

Why wasn't Avenue's equity portfolio's return better in 2015 given the US dollar exposure? The simple explanation is that the 7% return which we made on the US currency was offset by a decline in the Canadian holdings which fell about 10%. This was a negative year for utilities, real estate, energy and small cap stock which are the core of our Canadian exposure. On a positive note, we had previously reduced our exposure in many of these sectors. In the Fourth Quarter of 2015, we started to buy some positions back. We doubled our holdings of Enbridge Inc. and added AltaGas Ltd.

One of the harder decisions was to reduce our weighting to smaller companies. We think they offer exceptional value. But right now we would argue that any stock with less than a billion dollar market capitalization is experiencing a liquidity crisis. In plain language, there are no buyers. If an individual needs some money and the stock has to be sold, then the price goes lower until a buyer can be found. This is actually a complicated topic so we have expanded on this discussion in this quarter's Case Study on a Liquidity Crisis found on the next page.

The hard part of investing is often doing things that make us feel uncomfortable. The Canadian dollar looks and feels horrible yet we know the theory tells us the Canadian dollar is now good value. Also, the type of Canadian dividend paying stocks that we favour for their consistent income, offer attractive yields again, whereas over the last 2 to 3 years these stocks have been expensive. So as we enter 2016, we will look to gradually add investments in Canada where we can find a consistent business trading at a fair price.

